ROYAL LONDON US GROWTH TRUST

Quarterly Report 31 December 2020

For professional clients only, not suitable for retail investors

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Top 10 holdings

	Trust (%)
Apple	7.9
Microsoft	6.0
Amazon	5.8
JP Morgan Chase & Co.	2.3
Alphabet	2.3
Visa	2.2
Facebook	2.2
Alphabet	2.1
Verizon Communications	2.0
Johnson & Johnson	1.9
Total	**34.6**

Fund data

	Trust
No. of stocks	94
Fund size	£236.3m
Launch date	19.02.2001
Active share	56%
Tracking error	1.84%

Source: RLAM, based on the A Inc share class.

Performance

	Trust(%)	Benchmark[1] (%)	Relative (%)
Q4 2020	**7.25**	**6.88**	**0.36**
Year-to-date	16.08	17.00	-0.91
Rolling 12 months	16.08	17.00	-0.91
3 years p.a	11.96	14.30	-2.35
5 years p.a	15.85	17.28	-1.43
10 years p.a	14.20	15.53	-1.34
Since inception p.a. 19.02.2001	7.55	8.45	-0.89

Past performance is not necessarily a reliable indicator of future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

Source: RLAM, based on the A Inc share class.

All performance figures stated gross of fees and tax unless otherwise stated, subject to rounding.

[1]Benchmark: MSCI US £ Net Total Return Index

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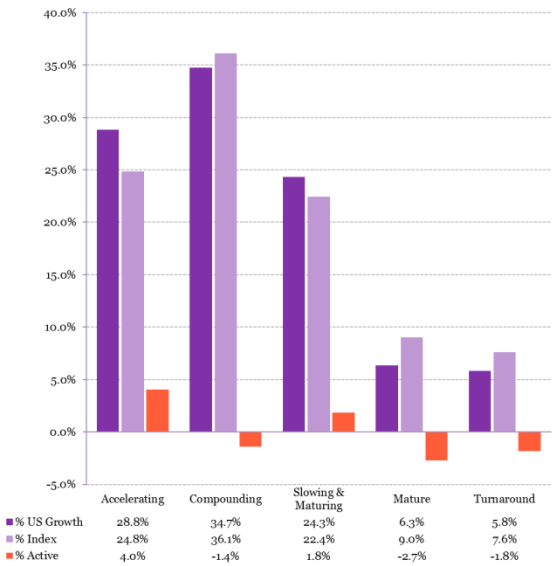
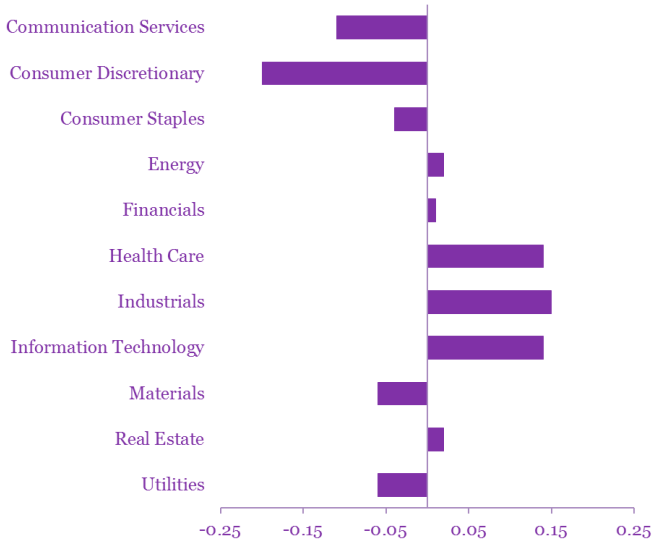
Holdings and weights



Sector weights



Source: RLAM as at 31 December 2020

Executive summary

- The fund recorded a net return (A Class, Income) of +6.98% for the fourth quarter, compared with +6.88% for the MSCI US Net Total Return Index (in sterling).
- Covid-19 cases generally increased over the quarter with a more transmissible variant spreading quickly in parts of the UK and other countries, leading to tighter restrictions. However, strong efficacy data in early November and subsequent regulatory approval allowed vaccination programmes to start. As a result, investors looked through the short-term challenges to the possibility of a strong economic recovery in the second half of 2021. Political issues were also prominent. Financial markets responded positively to the expected combination of a Biden presidency with a Republican Senate, even though two seats in Georgia required a runoff in early January. Congress finally agreed a $900bn (4% GDP) fiscal deal.
- As with previous quarters, the market recovery may seem surprising given the ongoing Covid-19 crisis and the economic impacts of lockdowns and other restrictions. Indeed, the pandemic has had clear negative impacts on corporate performance, which in some cases look to be structural rather than a shorter, cyclical hit. However, the monetary and fiscal responses have been equally dramatic, and have driven down fixed income yields to very low levels and equity discount rates to over 20-year lows. Although positive vaccines developments helped global markets, most were already up year-to-date before that news broke. While more transmittable strains of Covid-19 represent a near-term challenge with the need for tighter restrictions, a number of other risks have lifted, including whether vaccines could be developed and US political risks. While the first half of the year could be particularly volatile, the Federal Reserve (Fed) remains committed to supportive monetary policy and there are prospects for greatly increased fiscal packages under the Biden presidency.
- We are conscious, however, that following the remarkable recovery of equity markets from their lows in late March, valuations are less compelling. Using some valuation metrics, equities are the most expensive for several decades, and are approaching valuation peaks reached in the dotcom boom in 1999/2000. Nonetheless, relative to bonds, while clearly more expensive than at points in 2020, equity valuations are still not extreme and are actually lower than in 2018. We also believe earnings momentum will remain favourable. We believe sectors will be a key point of volatility risk, with the rotation into more cyclical/Covid-recovery stocks in the autumn showing the potential for positive and negative effects on performance. We are addressing this risk by minimising factor exposure to sectors and focusing on stock-specific risk.
- Our preference is to own wealth creating companies with suitable balance sheets for their underlying business and a conservative approach to credit diversified across regions, countries, industries and Corporate Life Cycle categories. No single model or analysis is a magic bullet for investing, but our Corporate Life Cycle model helps us to understand the world as management teams see it and identify those that are actively responding to the crisis. Owning companies that merely survive the pandemic won't deliver significant outperformance. We are looking for the 'Accelerators' that are increasing

investment to take full advantage of the current environment, and 'Slowing & Maturing' or 'Turnaround' companies that are doubling down on restructuring with an attractive valuation pay-off opportunity.

Market commentary

- Major global stock markets delivered a strong fourth quarter. The MSCI World Index rose +7.9% in sterling terms. Remarkably, despite the pandemic, 2020 as a whole posted positive returns (+12.3%). All major markets rose during the quarter with the dispersion in returns resulting more from sector rotation. Among the major regions, emerging markets, Asia Pacific excluding Japan and the UK were the stronger markets, whereas Japan, Europe excluding the UK and the US were slightly more pedestrian. The MSCI US Net Total Return Index returned +6.88% in sterling terms in the fourth quarter and +17.00% for the full year..
- Leading central banks, including the Fed, European Central Bank and Bank of England continued to neutralise the impact of government bond issuance through asset purchases. In addition, the removal of roadblocks to the dispersal of the €750bn EU Recovery Fund was a significant positive for European economies. With renewed lockdowns in many countries and activity remaining below normal levels, yields on benchmark 10-year government bonds fell over the quarter in most major developed markets, apart from the US, Canada, Sweden and Japan. Credit spreads tightened further reflecting optimism that vaccines will be successful and ongoing support for struggling companies.
- Sterling was among the stronger major currencies over the quarter, strengthening another 5.4% against the US dollar following the recent decision by the Fed to alter its inflation targeting methodology. This tempered the returns for sterling investors in US equities.
- Oil prices recovered strongly in the quarter as global economy continued to grow and Saudi Arabia announced production cuts. The price of Brent crude oil rose by +26.5% to over US$52 a barrel. Copper continued to strengthen as economic activity strengthened in China, rising +15.8% over the quarter. Gold fell -0.2% to US$1,933/oz., although this masked its volatility across the quarter as some investors sought a safe haven on renewed fears about Covid-19 and political risks.

Fund performance and activity

- The portfolio's robust construction ensures a high level of idiosyncratic risk and reduces sensitivity to macroeconomic factors – such as credit spreads, rates and commodity prices. This is in line with the fund's objective of providing long-term alpha via a focus on wealth creation and valuation, rather than taking on shorter-term exposures to sectors and macro themes.
- As in recent quarters, sector dispersion was wide. Companies that had been struggling because of Covid-19 tended to perform well on the Pfizer vaccine news, while several sectors rose on the prospect of a more traditional US president and gridlock in the legislative bodies preventing extreme policy decisions. Unlike prior quarters, it was not technology that led sectors (+6.8% in sterling terms during quarter), but a strong recovery in energy (+20.3%) and financials (+17.4%), which had previously underperformed. For the full year, however, energy was still down -36.3%.
- Over the quarter, **Micron** and **Trade Desk** contributed strongly to performance. These outperformers were offset by weakness in consumer staples holdings, like **Church & Dwight** and **McCormick**, and other stocks perceived to have defensive cashflows, such as **Verizon Communications** and car insurer **Progressive Corporation**.
- Volatile market conditions and the rotation away from highly-rated growth companies to 'Covid-recovery' stocks provided opportunities to add to some holdings at attractive prices. In terms of strategy, we increased the balance towards the more leveraged stocks in the fund, such as financials, chemicals and energy stocks. We also initiated positions in **Nvidia** (at the end of the quarter, following underperformance), where the wealth creation potential is strong and not fully discounted, funded by reducing exposure to **Tesla**; and **Pinterest**, which we funded by reducing **Alphabet**. Otherwise, we conducted a review of the medical equipment and technology sector, reducing **Thermo Fisher Scientific**, **Medtronic** and **Danaher** to initiate positions in **Intuitive Surgical**, **Idexx Labs** and **Mettler-Toledo**, and add to **Stryker**. We also decided to sell down **Omnicom**, feeling there are better opportunities elsewhere.

Key views within the fund

- The trust aims to deliver above average medium- to long-term capital growth by investing in a diversified portfolio of US equities, and will typically hold up to 100 stocks. The equities in which the fund invests may be from any sector, industry or market capitalisation. The fund aims to maximise the stock specific views from the US equities held in the Royal London Global Equity Diversified Fund, while minimising exposure to macroeconomic and sector influences using an optimisation strategy.

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- We are fundamental, bottom-up investors and therefore don't invest according to top-down macroeconomics. The broad economic environment will have an effect, but we believe that good companies perform well across the economic cycle. What matters more is how the company is using its capital.
- Our Corporate Life Cycle model categorises companies according to their stage of development. We believe that corporate returns on productive capital and growth tend to progress along a cycle with five defined stages: Accelerating, Compounding, Slowing & Maturing, Mature and Turnaround. We seek portfolio diversification across the Corporate Life Cycle.
- Quantitative analysis helps us to identify potential opportunities by scoring stocks across a range detailed financial factors. We then apply our scoring system to rank characteristics to identify which companies to research further for possible inclusion in the portfolio.
- Stock selection really matters: looking at MSCI World Stock Returns between 2014 and 2019, the worst performing 80.2% of stocks performed behind the benchmark, with a third losing value, whereas the best performing 19.8% of stocks represented 99% of the excess return.

Outlook

- While new, more transmittable strains of Covid-19 represent a near-term challenge with the need for tighter lockdowns, a number of other risks have largely lifted, including whether vaccines could be developed, US political risks and the UK-EU trade talks. While the first half of the year could be particularly volatile, governments and central banks remain committed to supportive monetary and fiscal policies.
- We are conscious, however, that following the remarkable recovery of equity markets from their lows in late March, valuations are less compelling. They are challenged in many areas and using our global discount rate methodology are approaching the extremes seen in the Tech Bubble. Nonetheless, relative to bonds, while clearly more expensive than at points in 2020, equity valuations are still not extreme and are actually lower than in 2018. We also believe earnings momentum will remain favourable. We believe sectors will be a key point of volatility risk, with the rotation into more cyclical/Covid-recovery stocks in the autumn showing the potential for positive and negative effects on performance. We are addressing this risk by minimising factor exposure to sectors and focusing on stock-specific risk.
- There will be challenging periods in the year ahead. At a macro level, a reversal in the bond markets similar to 1994 would impact equity returns as would a change in perception around central bank support. In this respect, the sustained rallies in oil, copper and other commodities could create a headwind to the expectations of lower rates for longer as higher input prices could feed through to inflation if they're not absorbed by manufacturers. This may challenge the current low rate environment orthodoxy, which has been a contributor to the outperformance of growth stocks. There are also signs of increasing costs elsewhere with container rates from China to the Los Angeles having more than doubled since the start of 2020. Other than these risks, there will no doubt be stock-specific hits from earnings releases or trading statements for companies that fail to meet the high expectations of analysts and investors. Some technology stocks that pulled forward demand in lockdown could be vulnerable once we move to more normal conditions.
- The benefits of our disciplined investment approach – a focus on stronger business models combined with robust portfolio risk controls – enable superior stock wealth creation and valuation to drive long-term performance. As vaccination programmes roll out and economic conditions normalise, we see opportunities for the underlying stability of many of the businesses to be better reflected in valuations. We believe that active equity managers, in particular, will perform well in the recovery from the pandemic. The crisis will result in strong companies (high returns, strong balance sheets and good 'moats') getting stronger as they are better able to take advantage of opportunities, whether through new areas of demand or having better balance sheets to navigate through lower levels of cash generation in most industries.

More from RLAM

- To find out more about our investment approach and current thinking, please visit rlam.co.uk.
- Talks from the online *RLAM Investment Series* that was held in the week of 28 September 2020 can be viewed on BrightTALK.com; including Will Kenney's *The growth vs. value debate: is it real or relevant anymore?*; James Clarke's and Carlota Garcia-Manas's *Responsible global equities*; and *Developing the equity solutions of the future* by Matt Burgess. Each presentation lasts for 30 minutes, including Q&A.
- You can find more of our thoughts on the opportunities and risks in the year ahead in our RLAM Outlook 2021 document.

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